NEWPORT LEGACY ZURICH SWITZERLAND: CAPITAL PERSPECTIVES: THIEVES, FLOODS, INFLATION AND INTEREST RATES

Who loses sleep over a potential “thief in the night”? Bond market participants certainly haven’t been too worried lately. Former Federal Reserve Chair William McChesney Martin used that turn of phrase to describe price inflation during his nearly two-decade run at the Fed.

Interest rates are (quite logically) inextricably linked to inflation expectations. Lenders typically expect their borrowers to compensate them for the expected erosion in real, or inflation-adjusted, value of the funds between the time they are borrowed and the time when they are eventually repaid. This inflation compensation is implied within the agreed upon interest rate for any given loan. As expectations for inflation increase, interest rates move higher.

In the late 1990s, the U.S. Treasury Department embarked on a novel approach to index the principal amount of some of its bonds to inflation. The actual amount a bondholder (i.e. lender) receives at maturity for these Inflation-Protected Securities, or TIPS, increases with inflation. Since a holder of TIPS is insulated from inflation risk, we can compare the market-driven yield for traditional Treasury notes with TIPS to help discern the inflation expectations of Treasury bond market participants.

The chart below depicts the implied expected annual inflation rate for the next 10 years (white line with blue body) alongside the 10-year U.S. Treasury yield, charted over the past 12 months. One can immediately discern a strong correlation between the two (proving our above point that rates and inflation expecations are positively correlated). One might also note that while the two moved up by comparable magnitude through January, since then inflation expectations remain anchored at 2.1-2.2 percent but the nominal 10-year Treasury yield has continued its march higher, especially recently.

10-Year U.S. Treasury Yields & Implied Inflation “Break-Even” Expectations

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Source: Bloomberg LP

This begs the question, if the inflation outlook has not changed, why do interest rates keep rising? We've heard optimistic market commentators citing stronger economic growth as the key driver for higher rates. This is a conceivable explanation but there are two other big factors which are actually quite important.

First, the U.S. federal government is running larger budget deficits. In light of the recently passed tax cuts, revenue for the 2018 fiscal year is estimated by the Congressional Budget Office to be essentially flat, while spending increased by 4.4 percent year-over-year.

Secondly, the U.S. Federal Reserve's planned balance sheet reduction, to unwind extraordinary financial crisis era stimulus, recently hit high gear. Starting in October 2018, the Fed will allow $50 billion per month of government-guaranteed bonds to mature without reinvesting, effectively soaking up an extra $50 billion of global liquidity each month, up from a rate of $10 billion this time last year.

Net federal government borrowing literally doubled over the past year, when comparing the past 12 months through Sept. 30 to $1.04 trillion, according to SIFMA data. Trillion! There is just a ton of incremental government borrowing for the market to absorb. Basic economics argues for a higher cost of something as demand increases. Higher rates have wide-ranging implications for all sorts of asset prices. The thief is currently at bay, but interest rate floodwaters are ominously rising.

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